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SUBJECT: European Financial Market Regulatory
Infrastructure: Bigger Before it Gets Better; A European
Financial Services Authority a Matter of Time?

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¶1. (SBU) Summary: The European Commission's November 6 launch of measures to extend the Lamfalussy procedures beyond securities to banking and insurance means all financial services governed at the EU level will be covered by a combination of policy and supervisory committees. The Committee of European Securities Regulators (CESR), established just over two years ago, will expand its coverage under the Commission's decision. New accounting committees have been created and others are proposed for the auditing area. Growing like topsy.

¶2. (SBU) The Lamfalussy procedures were to streamline and facilitate rule-making, thereby being responsive to changes in dynamic financial markets. To date, experience in the securities area generally has been positive, but not uniformly so. Too much detail in directives and implementing measures detracts from flexibility, according to the Inter-Institutional Monitoring Group that reviewed the operation of the procedures to date. Market participants shared that view and then some, criticizing (a) rushed consultations as political agendas triumphed technical considerations; and (b) lack of transparency in the activities of the European Securities Committee. Some of these criticisms will be overcome as committees work through their start-up problems. Others will, no doubt, arise.

¶3. (SBU) Longer-term, however, some observers believe the multitude of committees, cumbersome procedures and inter-relationship of banking, securities and insurance issues may give rise to a European Financial Services Authority (EFSA). To make this long-term goal a reality, its proponents would like the Constitutional Treaty for Europe to contain an enabling clause to allow for the creation of an EFSA - whenever the time is right. End Summary.

Expanding Lamfalussy: Banking, Insurance and CESR Plus

¶4. (SBU) On November 6 the European Commission launched a package of measures to extend the Lamfalussy procedures to banking and insurance activities. Four Commission decisions would create two policy-level committees, the European Banking Committee (EBC) and the European Insurance and Occupational Pensions Committee (EIOPC), and two regulatory committees, the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). In addition, two other Commission decisions would extend the purview of the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR) to include asset management and investment funds.

¶5. (SBU) The Lamfalussy procedures, recommended by a group of wise men chaired by Baron Lamfalussy, were adopted just over two years ago for the securities sector. CESR was established to provide the EC advice on legislation and implementing measures as well as to coordinate implementation and enforcement of EU securities legislation. The ESC, composed of member state Finance Ministry representatives, was created to approve implementing measures proposed by the EC. In this way, the Commission could adopt regulations (with immediate binding effect in member states) or directives (required to be transposed into member state law) without going back to the Parliament. The Commission is about to adopt implementing measures, one regulation and two directives, for the market abuse directive. This marks the first time Lamfalussy procedures have produced implementing measures.

¶6. (SBU) Two problems have arisen with the new expansion. First, location. While Finance Ministers agreed on the need for the new committees, they are having more difficulty

settling on the location. The UK wants the banking regulatory committee (CEBS) to be in London, Germany wants it to be in Frankfurt. One solution would be to have all committees based in Paris. However, CESR is based in Paris and the French have given no signs of yielding this morsel. To date, stalemate.

¶7. (SBU) The other problem is the Parliament. The Commission will suspend the decisions on the creation of EBC and EIOPC and expanding the ESC and CESR's area of competence until the Parliament passes a directive which substitutes these new committee names for those of existing committees, such as the Bank Advisory Committee. The legislation would need to move quickly, before the Parliament adjourns in April. The Commission's goal is to have the new committees in operation by the beginning of ¶2004. The EBC would be tasked with a new proposed capital adequacy directive and the EIOPC would similarly take up new insurance legislation. The Parliament, however, is likely to play hard to get.

Parliament: Conditional Blessing

¶8. (SBU) Parliament has not been comfortable with the Lamfalussy procedures, fearing that the Commission and Member States could adopt implementing measures beyond their authority as defined by directives. Not having the "right to call back" such legislation, Parliament has inserted "sunset" provisions in securities legislation specifying that the Commission's authority to adopt implementing measures will expire unless renewed by the Parliament. Parliament is angling for a call back right in the Treaty via the proposed draft Constitutional Treaty for Europe currently under consideration by the Inter Government Conference. The recent draft gives them satisfaction. But it is still a draft.

¶9. (SBU) The Chairman of Parliament's Economic and Monetary Affairs Committee (EMAC), Christa Randzio-Plath greeted the Commission's decision to expand the Lamfalussy procedures with two conditions: (1) Finance Ministers to declare publicly that the procedures foreseen in the draft Constitutional Treaty for Europe will apply to the adoption of implementing measures and enter into an agreement with Parliament to that end pending entry into force of the Constitutional Treaty; and (2) that the new committees have "real functional and operational independence," and not act as "mouth pieces for the Commission or the Council." The former may be hard for Finance Ministers to swallow, but within their power to do so. The second is so vague as to be either no problem or an impossibility.

CESR et. al.

¶10. (SBU) Since its creation in June 2001, CESR has been growing and busy. The Secretariat has grown to 15 and moved into new quarters. Eight of the ten candidate countries joined CESR in 2003 as observers.

¶11. (SBU) CESR Fin, a standing committee on financial issues, has issued a standard on financial information to develop a common approach to the enforcement of International Financial Reporting Standards (IFRS) in Europe. CESR Fin has also issued two drafts for public comment, one for a recommendation on guidance regarding the transition to IFRS (all EU listed companies must have their accounts prepared according to IFRS for financial year 2005) and the other for the coordination of standards enforcement activity.

¶12. (SBU) CESR has two Expert Groups on implementing measures, one on market abuse the other on the prospectus directive. Both expert groups have issued consultation papers, held public hearings, and delivered advice to the Commission. Another Expert Group is being established on the Investment Services Directive composed of three subgroups (market regulation, rules of conduct of intermediaries, and enforcement). CESR has worked with the European Central Bank (ECB) to produce draft standards on clearing and settlement. Getting a jump on the Commission's decisions, on October 30 CESR issued a consultation paper on how it sees its new role in the regulation of asset management and investment funds.

¶13. (SBU) The Lamfalussy procedures, or at least the committee structures, are being adopted in other areas covered by the EU's Financial Services Action Plan. To implement the International Accounting Standards Regulation there is a policy level European Accounting Committee and a technical committee called EFRAG, the European Financial Reporting Advisory Group. On auditing, the Commission has proposed to create an Auditing Regulatory Committee and to rename the EU Committee on Auditing to the Audit Advisory Committee, a forum of regulators. A new Financial Services

Committee, a re-worked version of the Financial Services Policy Group but chaired by a member state representative, is to give overall strategic guidance and set medium-term objectives.

¶14. (SBU) With Lamfalussy procedures spreading hither and yon, it would seem like the procedures are really great. Maybe in theory, but not yet in practice.

IIM and the Market: Good and Better, but A Long Way from Best Practices
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¶15. (SBU) To shed light on whether Lamfalussy procedures have been working well in the securities area an Inter-Institutional Monitoring Group of independent experts made an assessment and published an interim report in May. Broadly speaking, the evidence they collected has been "strongly supportive" of the procedures, though admitting that there is a "learning by doing" experience underway suggests room for improvement. The IIM highlighted some important issues, including the possible sacrifice of quality to meet self-imposed deadlines of the FSAP and too much detail in directives that would impede flexibility in implementation to respond to changing market conditions.

¶16. (SBU) Others, responding to an invitation of the IIM to comment on its interim report, were less generous. A group composed of the Federation of European Securities Exchanges, the International Primary Dealers Association, the International Securities Market Association, the London Investment Bankers Association and the European Banking Federation submitted joint comments. They asserted that the process has yielded "far too much detail" in directives and implementing measures that has resulted in decisions taken by "politicians on matters that require detailed technical knowledge" leading to political deadlock. Too much detail, in the group's view, is incompatible with the diversity of the European market and will present difficulties when the time comes to update the measures.

¶17. (SBU) CESR consultations procedures look good on paper, according to the group, but have been rushed in practice. Time limits have "prevented satisfactory second rounds of consultation and consultation documents are too long given the time to respond to them." The European Securities Committee, composed of member states, "has perhaps the farthest progress to make to become sufficiently transparent." This is in contrast to CESR, in the group's view, which has adopted a charter with principles for consultation and used both open public consultation and expert groups to consult on its work.

¶18. (SBU) Finally, the group seconded the IIM's assessment that CESR, the Commission and market participants all have resource constraints in developing and enforcing legislation and regulation. A possible way out, according to this group, would be to reduce the level of detail in legislation and implementing measures and "give greater weight to the less politically-driven" implementation level of the Lamfalussy procedures where national authorities coordinate national implementation measures via CESR.

Enter an EFSA: A Matter of Time?

¶19. (SBU) The latter comment raises the question of whether the EU would be better served by having a European Financial Services Authority (EFSA). Such an organization, operating under broad legislation proposed by the Commission and adopted by the Parliament and the Council, might be just want that group is looking for - at least on paper.

¶20. (SBU) Deutsche Bank's research staff has praised the Lamfalussy procedures but considers them an intermediate step to a single regulatory and supervisory authority. Lamfalussy would probably agree. Reportedly he once quipped that not following his recommendations would lead to the creation of a EU supervisory authority and following them would lead to the same result.

¶21. (SBU) The European Economic Advisory Group (EEAG) composed of European academics working through Munich's Ifo Institute arrived at a similar conclusion, but with a view to promote market integration and financial stability. With respect to integration, EEAF reasons that an EFSA might better resist local pressure to assist particular institutions. On financial stability, EEAG argues that cross-border financial activities within the EU has made "mere coordination" of financial supervision as likely to be insufficient. Thus, the need for a more centralized supervision mechanism.

¶22. (SBU) EEAG believes that the ECB could assume responsibility for more centralized banking supervision and

a European Securities and Exchange Commission could supervise securities markets. However, they note that a strong case for an EFSA that covers banking, securities and insurance is based on the trend toward integration of intermediaries and market operations as well as avoiding any potential conflict between conduct of monetary policy and supervision of the financial system.

¶23. (SBU) EEAG states that supervision need not be completely centralized but rely on national authorities. Deutsche Bank has argued for a similar approach, modeled on the ECB structure, with the central authority (like the ECB's Governing Council and Executive Board) developing principles and guidelines and coordinating their implementation, but relying on national authorities (like the national central banks in the euro system) to perform the actual supervision and enforcement. To put an EFSA into place would require a change in the treaty. Deutsche Bank and others have called for the Inter Governmental Conference to insert an enabling clause into the Constitutional Treaty for Europe, for use if and when appropriate.

¶24. (SBU) In October the Initiative for Finanzstandort Deutschland, a group of German banks promoting Germany as a financial center, endorsed the idea of a European Financial Supervisory Authority. A Bundesbank Board member immediately criticized the initiative as "illusionary," claiming that such an EFSA would need to have a European political union before it could work. That's the same thing critics said about European Monetary Union and the ECB.

Comment: Against the Wind

¶25. (SBU) Creation of EU committees is hardly news. The Lamfalussy procedures themselves are a form of the EU "comitology," well established in some other areas. What is new is that the securities committees are now an integral part of implementing, enforcing and amending EU directives and implementing measures. Spreading this to banking and insurance would give these groups more influence than their predecessors. The other side of the coin is that all of these groups will have more significant responsibilities under the directives and regulations being adopted under the FSAP.

¶26. (SBU) Working through the new procedures is cumbersome. Although it would be ironic to concede that the once closed EU rule making process in financial services now offers too much consultation, some market participants admit to "consultation fatigue." Consultations with the Commission when it is working on a proposal, with the Parliament and Council when they are considering the proposal, with CESR Expert Groups in developing advice to the Commission, and again with the Commission and possibly the ESC, when considering adopting implementing measures based on CESR's advice does seem excessive. Collapsing these procedures into a EFSA could help eliminate a step or two, but, would still involve more consultations than has been the case to date for EU level legislation on financial services.

¶27. (SBU) Added to such practical advantages are those pointed out by EEAG - a potentially easier path to integration and better coordination for implementation and enforcement. Taken together, the arguments for a single entity become stronger. The senior Bundesbank official that has downplayed the probability of an EFSA was the same one who had fought for the Bundesbank and the ECB to have a greater role in banking supervision. He lost that debate. Once more, he may be leaning against the wind.

¶28. (U) This cable coordinated with Embassy Berlin.

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